October 27, 2017

SEC Announces Measures to Facilitate Cross-Border Implementation of the Research Provisions of MiFID II

Three No-Action Letters Permit Broker-Dealers to Unbundle Research Fees from Commissions without Being Regulated as Investment Advisers; Permit Continued Reliance on Exchange Act Section 28(e); and Allow Investment Advisers to Continue Aggregating Trade Orders

On October 26, 2017 the staff of the Securities and Exchange Commission (the "SEC") issued three no-action letters addressing concerns expressed by the broker-dealer and investment management communities about the impact of the European Union's Markets in Financial Instruments Directive ("MiFID II") on the way research is paid for.

U.S. broker-dealers that disseminate research generally include any fees for their research in their brokerage commissions rather than billing for it separately.[1] The portion of commissions that is attributable to research is referred to as "soft dollars." Statutory provisions and interpretive guidance from the SEC have taken into account the industry's extensive use of soft dollars.

In particular, the definition of "investment adviser" in Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (the "Advisers Act") generally excludes a broker-dealer who provides advisory services, including the dissemination of research, if its performance of such services is solely incidental to its brokerage business and it receives no special compensation for such performance. Payment received through soft dollars is not considered "special compensation;" accordingly, a broker-dealer disseminating research for soft dollars is not thereby an investment adviser. This is of consequence to broker-dealers because investment advisers are held to a fiduciary standard and, in many cases, are also subject to registration with the SEC or one or more states. In addition, Section 28(e) of the Securities Exchange Act of 1934

(the "Exchange Act") expressly provides that a person, such as a money manager, who pays for research using soft dollars is not acting unlawfully or breaching a fiduciary duty, subject to various conditions, even if a particular client's soft dollars are used to acquire research or brokerage services that are for the benefit of other clients. Separately, SEC staff guidance under the Advisers Act and the Investment Company Act of 1940 (the "Investment Company Act") permits investment advisers to aggregate orders for multiple clients to achieve efficiencies, subject to various conditions. One such condition is that each client must participate at the average price paid or received for securities and must pay its pro rata share of all transaction costs, including soft dollars.

MiFID II requires the unbundling of commissions and fees for research in the case of research sent to a recipient in the E.U., or sent by a broker-dealer located in the E.U., commencing January 3, 2018. This change has significant implications for U.S. broker-dealers and investment advisers that transact with E.U. firms:

- MiFID II will require U.S. broker-dealers providing research to the E.U. firms to bill separately for that research. Direct payments for research are likely to be viewed as "special compensation" under the Advisers Act, causing those U.S. broker-dealers to become investment advisers under the Advisers Act.
- Investment advisers who receive research from E.U. broker-dealers will be required to pay separately for research, calling into question the continued availability of Section 28(e) of the Exchange Act where client assets are used to pay for research or brokerage services.
- Unbundling research fees will make it impossible for investment advisers to comply with the requirement in staff guidance on the aggregation of client orders that each client must pay its pro rata share of all transaction costs.

The three no-action letters issued yesterday address these concerns by providing, in substance, that the staff will not recommend enforcement action:

- under the Advisers Act against a broker-dealer that provides research to a customer that is required under MiFID II to pay for the research from its own money, or from a separate research payment account ("RPA") funded with client money (or a combination of the two);[2]
- against a money manager seeking to operate in reliance on Section 28(e) of the Exchange Act if it pays for research through the use of an RPA that conforms to the requirements for RPAs in MiFID II, and the executing broker-dealer is legally obligated to pay for the research, provided that all other applicable conditions of Section 28(e) are met;[3] or
- under the Advisers Act or the Investment Company Act against an investment adviser that aggregates orders subject to MiFID II with unbundled research fees, subject to certain conditions, including that each client pays (or receives) the average price for the security and the same cost of execution, and that the related payments for research will be consistent with local requirements and disclosures to the client.[4]

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ENDNOTES

[1] This practice developed during the era of fixed brokerage commissions as a way for brokerage firms to compete for trading volume.

[2] *See* Sec. Indus. & Fin. Markets Ass'n, SEC No-Action Letter, 2017 WL 4841940 (Oct. 26, 2017). This first item of relief is temporary, lasting 30 months from MidFID II's January 3, 2018 implementation date. During the period of temporary relief, the staff will "monitor and assess the impact of MiFID II's requirements on the research marketplace and affected participants in order to ascertain whether more tailored or different action is necessary."

[3] *See* Asset Mgmt. Group, Sec. Indus. & Fin. Markets Ass'n, SEC No-Action Letter, 2017 WL 4841941 (Oct. 26, 2017).

[4] *See* Inv. Co. Inst., SEC No-Action Letter, 2017 WL 4841939 (Oct. 26, 2017).

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